THE PRIVATE SECTOR IN SRI LANKA SINCE 1977

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The Private Sector Before 1977

The state of the private sector which confronted the new government of Sri Lanka in 1977 was a rather sorry one, although it reflected patterns all too familiar in a great many developing countries. The colonial structure of the economy had left independent Ceylon with an initially lopsided private sector in 1948: highly developed plantation industries and a financial structure geared to the import/export trade combined with a minimal industrial base and little effective institutional capacity to mobilize investment resources. Over the next 30 years the situation improved marginally in some areas and deteriorated severely in others. Both political blocs in Ceylon sought to promote industrialization, but the early efforts were naive, if well intentioned. The maze of industrial policies promulgated by alternating UNP and SLFP governments left Ceylon with a set of inefficient import substitution industries surviving behind excessive rates of effective protection and a lack of incentives for export industries which kept Ceylonese industrialists out of the international marketplace and sheltered from the winds of international competition.

Private firms developed within the framework of the Companies Act of 1938, a colonial modification of the British Companies Act of 1929, which was still in force in 1982. The law did not provide for the firms of corporate structure which have been most effective in promoting capital mobilization in the developed world, and the vast majority of Ceylonese forms continue to be family enterprises or closely held firms. Although a few plantation

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stocks have traded on the local exchanges for a very long time, the capital markets of Ceylon were not developed in ways which facilitated the financing of company equity. Most firms continued well into the 1970s on a mixture of short-term commercial financing and limited medium- and long-term debt financing from informal noninstitutional sources (family, friends, the "black money" pool, private unregistered financial intermediaries, and the like). While the financial agility of the noninstitutional money markets in Sri Lanka is noteworthy and even commendable, as is the ingenuity of local entrepreneurs who built enterprises with this financing, the underdevelopment of formal capital markets in Sri Lanka took its toll in a number of ways. The noninstitutional finance market is inherently inefficient because it cannot use public channels to move market information on supply and demand for funds. It also lacks the ability to achieve economies of scale and typically involves unnecessarily high transaction costs for both borrower and lender. It favors debt financing over equity financing with an inevitable bias towards expansion of existing enterprise over new starts.

The only element of the financial structure in Sri Lanka which was well developed before independence was the commercial bank capacity to handle documentary credits and import/export finance. Even this function had been eroded in the 1970s as foreign exchange availability dwindled and the government nationalized the large commercial banks. Not surprisingly, the composition of the private sector in Sri Lanka by 1977 was weighted heavily towards the trade and service sectors which lend themselves to small-scale and debt financing.

The years between 1971 and 1977 were difficult years at best for all private sector firms and disastrous for many firms. With hindsight it is clear that the basic sectoral investment policies of the government during this period were misguided in the extreme. Public enterprises and ill-conceived welfarism consumed the lion's share of public resources, while confiscatory tax policies and direct expropriation of private businesses turned a weak private investment climate into a virtually nonexistent investment climate. Over and above mismanagement at the macrolevel, Sri Lanka was plagued by a convergence of other economic forces which dampened economic performance as a whole and took a particularly high toll in the private sector. Foreign exchange availabilities dwindled severely during the period, and the private sector was last in line at the foreign exchange allocation window of the socialist government. Sri Lanka's overall terms of trade deteriorated severely over the SLFP years, and the government's trade policies discriminated against exports (both manufactured exports and the major traditional plantation exports). Total economic performance for the period was dismal.

and growth in the private sector was probably negative for the period as a whole. Foreign investment in Sri Lanka, which had been minimal before 1971, dried up entirely in the SLFP years as the nation acquired an international reputation for being not simply neutral to private enterprise, but actively hostile to private business.

The Private Sector Policy Reforms of 1977

It was against this undeniably bleak setting that the new UNP government launched a sweeping economic liberalization program in which an important role was assigned to the private sector. Within months after the election, the government announced that its central industrial policy objective was to "encourage export-led industrial development in preference to import-substitution oriented industrial development that has characterized the period since the late fifties, since the latter has proved to be both uneconomic and incapable of generating employment."[1] The government sought more broadly to give major incentives to private producers in all the production sectors (industry, food crops, and traditional exports) and to create the conditions for private capital mobilization and investment which would free public investment resources for rehabilitation of Sri Lanka's sadly deteriorated infrastructure base.

The first UNP budget set out four overall economic objectives: (1) to revive the economy, (2) to increase output from agriculture, industry, and trade, (3) to stimulate domestic savings and investment, and (4) to improve the balance of payments. Two structural changes were promulgated very early on in the life of the new government to give substance to these policy objectives. First, *price controls were eliminated* (with the exception of bread and pharmaceuticals). Second, *import controls were virtually eliminated.* The government switched from a complex and inefficient system of import permits to a "negative list" of ineligible commodities. All nonprohibited imports could be freely imported against a simplified tariff structure with six bands ranging from duty-free to a 100% tariff.

In parallel with these policy changes, a number of important institutional initiatives were undertaken to unscramble the maze of bureaucratic authorities which claimed overlapping jurisdictions in the investment area. The most significant among the new institutions are:

1. *Greater Colombo Economic Commission (GCEC)*: Operates a free zone for foreign investors prepared to accept a 100% export obligation.

2. *Foreign Investment Advisory Committee (FIAC)*: Evaluates and approves all foreign investment outside the free zone operated by the GCEC. Such investments generally must include at least 51% Sri Lankan equity. FIAC can offer an array of incentives which correspond to the attractiveness of the project in terms of either technology transfer or employment creation.

3. *Local Investment Approvals Committees (LIACs)*: Three LIACs (fisheries, textiles, and general industries) have approval authority for domestic industrial investments. The LIAC approval confers access to government financing support and the right to open Letters of Credit (LCs) for equipment imports in excess of $35,000.

4. *Export Development Board (EDB)*: This body has broad responsibilities for promoting exports—especially nontraditional exports. It operates a variety of export rebate and export subsidy schemes and has a refinance window (operated in conjunction with the Central Bank of Ceylon) which can provide term financing up to 15 years for export ventures. The EDB also has the unusual ability to take equity positions in export companies through the purchase of redeemable preference shares for up to 20% of project equity.

5. *Sri Lanka Export Credit Insurance Corporation (SLECIC)*: The SLECIC conducts a wide range of commercial insurance and guarantee functions, including holding performance guarantees on bank-financed trade transactions for local exporters, financing of bid bonds for Sri Lankan firms tendering internationally, and conventional pre- and post-shipment credit guarantees on commercial LCs.

An important policy area for the private sector which has *not* received adequate attention in the first stages of the liberalization is tax policy. The Sri Lanka tax structure reflects the colonial structure of the economy. Indirect taxes on import/export transactions and domestic trade transactions have been the mainstay of government revenues throughout the current century. The increase in trade activity associated with the liberalization has accelerated revenues to government from this somewhat archaic tax structure, but the system induces undesirable distortions in the patterns of investment and commercial activity. Table 1 shows trends in the yield of the tax system over the past two governments.

Several features of the tax structure have particular salience for private sector policy. The most significant among these are the following. First, the present structure of Business Turnover Taxes levies higher rates on trade transactions than on manufacturing transactions. This provides additional disincentives for domestic manufactures and adds to other distortions which already favor trade over manufacturing. Second, the Business Turnover Tax (BTT) does *not* incorporate the features of a modern Value Added Tax which does not re-tax at successive stages of production. Quite the contrary,

TABLE 1 *Contributions of Sri Lankan Taxes to Revenue (percentage composition)*

Tax	*1971*	*1974*	*1978*	*1981*
Direct Taxes				
Taxes on income and profits	*19.9*	*15.3*	*19.6*	*14.1*
Personal	—	4.9	3.7	2.9
Corporate	—	10.4	15.9	11.2
Taxes on property and property transfers	*2.2*	*1.8*	*1.4*	*1.2*
Indirect Taxes				
Taxes on goods and services	*37.6*	*36.9*	*29.9*	*34.9*
Business turnover tax	14.6	15.4	10.4	19.7
Liquor	7.4	5.5	5.3	5.3
Tobacco	11.1	9.5	7.3	7.5
Tea (ad valorem)	1.7	4.1	4.9	0.7
Other	2.7	2.3	2.0	1.6
Import duties	*12.6*	*7.1*	*4.1*	*22.5*
Export duties	*11.9*	*16.9*	*40.8*	*27.3*
Tea	7.3	4.0	26.8	14.4
Rubber	0.6	7.3	9.7	10.3
Coconut	2.5	4.1	3.3	2.0
Other	1.6	1.4	1.0	0.7
FEEC revenue	*15.7*	*22.1*	*8.3*	—
Total tax revenue	100.0	100.0	100.0	100.0
Tax revenue as % of total current revenue	86.0	91.6	93.8	94.5
Non-tax current revenue as % of total current revenue	14.0	8.4	6.2	5.5

SOURCE: Central Bank of Ceylon.

the Sri Lanka BTT permits cascading taxes which can induce significant distortions into the manufacturing sector by discouraging forward and backward linkages between specialized manufacturers and by favoring simple one-step enterprises which transform feedstock into finished goods at a single site. Third, the application of the Business Tax to financial intermediaries has led to the treatment of banking profits in ways which serve as a disincentive to equity finance and project lending and favor conventional short-term commercial transactions. Fourth, the current tariff structure combines revenue and protection elements in a single tax which produces unintended effects in terms of effective rates of protection and contributes to the distortion of investment decisions in the private sector towards enterprises which are inefficient but over-protected. Finally, export firms and new joint-ventures enjoy a wide range of temporary exemptions from business and corporate taxation, but face uncertainty about the range of taxes they will confront when the exemptions expire. These uncertainties dampen willingness to expand or make major changes in the capital structure of private firms.

The Private Sector Response to the Liberalization of 1977

In developing countries which have experienced relatively long periods of socialist regulation of the economy and limited private access to the foreign exchange markets, there is an almost inevitable sequence of events which marks the early years of the liberalization. It is important to understand how universal these are as one seeks to assess the performance of Sri Lanka's private sector under the new regime. Most of the early period after a liberalization involves the satisfaction of pent-up consumer demand and the redirection of a scarcity-oriented trading and commercial sector to the operation of a free market. The conventional features of the early years after liberalization involve a sequence of events as outlined below:

(1) Imported goods flood the markets and the consumers are euphoric while traders grow rich overnight; (2) The new money from trade goes into real estate and land prices and rents rise dramatically—squeezing some while enriching others; (3) The banking system expands dramatically, attracting new deposits (usually in foreign exchange at near-Euromarket rates). Depositors are initially euphoric because of the high nominal interest rates; (4) The Consumer Price Index rises at historically unprecedented rates and euphoria begins to wither among the less favored groups; (5) Trade and commerce continue to predominate in the private sector and the government begins to worry about the problems of directing resources to productive investments rather than trade; (6) The banking and trading constituencies (who are making a killing in commercial transactions) resist pressures to diversify their investment portfolios towards production, and public criticism of financial intermediaries mounts; and (7) Government begins to reexamine the social

and political cost of liberalization and to consider alterations in policy to respond to the new distortions.

To date, Sri Lanka has kept rather closely to the liberalization libretto. The first years after 1977 witnessed massive imports of consumer goods as traders, conditioned by years of scarcity, overinvested in inventory and saturated the markets. Consumers, likewise accustomed to scarcity or at best to uncertainty in the marketplace, displayed the "hoarding" response which usually follows years of artificially restrained consumer demand. At the same time, free foreign exchange and new sources of commercial wealth combined with greater access to the banking system to fuel a housing and construction boom in 1978 and 1979. Speculation in real estate was rampant, and contractors and land speculators were among the earliest beneficiaries of the new policies. Inevitably there were some sharp market corrections after the initial frenzy, and the traders found themselves faced with unanticipated carrying costs on speculative inventory while the land market slackened somewhat in 1980. The liberalization had, however, undeniably reshaped the domestic economy of Sri Lanka, and evidence of the changes is abundant.

Nowhere was the impact greater than upon the patterns of income and wealth distribution in the island. While land and trade have long been the sources of substantial wealth in Sri Lankan society, the socialist interlude had diminished the returns to both, and the tenured urban salariat and the tenured small paddy farmer enjoyed greater economic security and a higher *relative* position in the income hierarchy of Sri Lanka than in the 1950s and 1960s. Predictably, the benefits of the liberalization flowed rather differently than the benefits of the socialist policies of 1971–77, and not all Sri Lankan households were equally well positioned to capture these new benefits from a free market economy. Households with at least one member in the commercial world (from street hawker to chairman of a finance house) gained two immediate advantages from the new policies: (1) their turnover increased dramatically, producing *more nominal income;* (2) their ability to pass costs through to the consumer allowed them to "index" their incomes in a period of increasing inflation and thereby assure that their *real incomes* kept pace with the economy.

Civil servants, pensioners, state enterprise employees, and the urban salariat in general saw elements of the cost of living rising faster than their incomes, and many households experienced a *relative decline* in their economic status. Government wage increases and the fact that most households were able to deploy at least one member into the private sector at some level (even agricultural and unskilled construction labor rates reflected the payout

from the liberalization) meant that it was unlikely that any large group in the society experienced an *absolute decline* in real welfare. This proposition may be debatable at the margins, but the combination of rising growth rates in the GNP and a substantial "safety net" of government welfare programs for those most in need probably ensured that most families preserved or improved their basic standard of living over the past five years.

Much of the debate over the outcomes of economic liberalization policies arise from the fact that individuals are more conscious of their relative economic status than their absolute economic status. If household "A" has a constant level of real income for five years while households "B" and "C" next door have a 50% increase in real income over the same period, then household A will feel that it has lost ground. High inflation compounds the problem because rapidly rising nominal prices create a perception of eroding buying power even when incomes rise in tandem with prices. If household A in Colombo bought rice at Rs 2 per kilo in 1977 (one Rs = US $0.05) and now pays Rs 5 per kilo, the fact that the household income rose from Rs 400 to Rs 1,000 per month will not mitigate the sense that life is becoming more costly. If household A also sees that households B and C have seen their incomes rise from Rs 400 to Rs 1,500 per month and now buy fancy rice at Rs 7 per kilo, household A will be positively convinced that its standard of living is deteriorating.

Precisely these phenomena have been occurring in Sri Lanka in the past year, 1982. Increasing public attention is being drawn to the relative shifts in income among different groups, and the ability of some households to prosper more rapidly under a free market regime is creating the *perception* that the liberalization has undermined social equity. The March 1982 decision of the Sri Lankan government to renege on its hardline policy decision not to index food stamps reflects the government's increasing sensitivity to these perceptions.

The government faces a multifold challenge in the next two years: first, to guide the economy past the "consumer euphoria" stage of liberalization towards sustained productive private investment; second, to adjust its welfare policies in ways which better reflect the dynamics of a liberal economy and avoid contributing to economic distortions; third, to take care that the institutional and policy developments which accompany the second stage of the liberalization are carefully attuned to the need to ensure the broadest possible participation in the free economy by Sri Lankans from all strata; and fourth, to consciously shrink the relative size of the public sector salariat by moving increasing responsibility for economic activity to the private sector and substantially slowing recruitment into all forms of public service.

These challenges are not insurmountable. They are the prerequisites for the movement from an "infant liberalization" to a "mature liberalization," and they have been successfully accomplished by a number of countries. They have also proved catastrophic stumbling blocks to many less developed countries, and the Third World is littered with "failed" liberalization attempts. To understand the issues confronting the government of Sri Lanka in the private sector policy area it is useful to examine the two basic elements upon which the liberalizarion depends: (1) the financial system to mobilize private capital and allocate investment resources; and (2) the productive base of the private sector in Sri Lanka today.

Financial Intermediaries: Performance Since 1977

While it cannot be argued that Sri Lanka now possesses the depth and variety of financial markets which it will need to achieve the ambitious industrial goals it has set for the coming decade, the development of local financial institutions since 1977 has been impressive indeed. The aggregate balance sheet of the commercial banks grew nearly sixfold from slightly more than Rs 4 billion in 1976 (the last full year of the SLFP government) to about Rs 24 billion in November 1981. Over the span of two years between their inception in 1979 and November 1981, the newly created Foreign Currency Banking Units showed a tenfold growth in foreign exchange assets from Rs 0.5 billion to more than Rs 5.0 billion.

A score of foreign banks have joined the seven banks which survived the socialist interlude, and the commercial banking sector was alive with competition for business in 1982. The 1971-77 period was not a total loss for the banking system since this period saw government-induced branching of the two public sector banks down to the lowest levels of village settlement. While the carrying costs of some of these village branches may prove too high and lead to retrenchment, the Colombo-based banking structure penetrated the entire island in the 1970s and this fact is unlikely to be reversed. As is always the case in new banking markets, there is some talk of Sri Lanka being overbanked, but this appears to reflect the complaints of the early entrants who now have to compete harder for business which fell into their laps in the early days of the liberalization.

Not surprisingly, banking activity has concentrated first on the easy and lucrative side of the liberalization—domestic and international trade transactions. The dramatic rise in imports after the election of 1977 heated up the Letter-of-Credit (LC) business and fostered unprecedented levels of demand for short-term commercial money. At the same time, depositors, still wary after the last government and uncertain about the direction of the market, kept their money short to preserve liquidity. The 1977-78 period had the earmarks of a trader's market (as in Hong Kong and Singapore in the 1950s) with private money moving at high velocity but only for short intervals. The term structure of deposits began to lengthen in 1980 as the government liberalized bank rate policy and permitted the yields on term deposits to rise to Euromarket levels (and above Euromarket in some instances). The early response of the banking system was to hold the term structure of their loan portfolios shorter than their deposit structure and balance their maturities in the Euromarket. This led understandably to complaints from the local business community that the foreign banks in particular were not carrying their fair share of the debt market and were in town simply to skim off the cream of the LC business.

Several factors conjoined in late 1980 and early 1981 to alter this picture. The new banks were beginning to get their feet on the ground and to size up the local investment market. Simultaneously, the government of Sri Lanka began (apparently with the encouragement of its external banking consultants) to exert some mild "moral suasion" on the foreign banks to take a more active interest in the term market. The results are already evident, and by November 1981 (latest month for which full banking figures are available) the tables had actually been reversed (see Table 2). *The term structure of the aggregate loan portfolio of the Foreign Currency Banking Units (FCBUs) is now longer than the term structure of deposits.*

TABLE 2 *Maturity Pattern of Deposits and Advances of Foreign Currency Banking Units as of the End of November 1981 (in millions of U.S.$ and Rs)*

Banking Units	*Deposits* *U.S.$*	*Deposits* *Rs*	*% of total*	*Advances* *U.S.$*	*Advances* *Rs*	*% of total*
Up to 3 mo.	166.3	3,423.5	75.3	122.3	2,516.6	58.5
Over 3 mo. to 6 mo.	33.3	683.2	15.0	14.7	303.2	7.0
Over 6 mo. to 12 mo.	1.1	23.8	0.6	10.7	221.0	5.2
Over 12 mo. to 3 yr.	20.0	441.9	9.1	29.0	597.2	13.9
More than 3 yr.	—	—	—	32.3	664.0	15.4
Total	220.7	4,572.4	100.0	209.0	4,302.0	100.0

SOURCE: Central Bank of Ceylon.

Given the natural proclivity of conservative bank managers to match maturities and to see offshore banking in developing countries as an opportunity to milk capital for safer loans in Europe, this turnaround is encouraging indeed. It represents a tangible vote of confidence in the Sri Lanka market and one which will not be missed by foreign investors who tend to look to offshore banks as bellwethers of the marketplace. It is worth adding the caveat that most offshore banks in Sri Lanka have low exposure limits and that the 15% of bank funds out at three years or more is only U.S. $32 million spread among a considerable number of clients. There is still a very long way to go in developing the depth and range of term finance which will be needed to sustain a strong private sector in Sri Lanka, but the early signs are auspicious.

TRENDS IN THE LENDING PORTFOLIO

Commercial finance still dominates the portfolio of most commercial banks in Sri Lanka, but the picture is changing in directions which are positive. Government banking policy permits a relatively wide band of interest charges, and banks are able to offset the higher risks of term lending with higher rates. While *real* interest rates on most loans continue to be negative (i.e., interest rate is lower than most conventional inflation measures), they are high in absolute terms (most loans from the commercial banking system are in the 17–22% band, while long-term financing from state credit institutions ranges more widely from 5% to 25%). The impact of these high nominal rates of interest is to favor enterprises and ventures with relatively fast payout periods. Table 3 gives the purposes for all loans in the aggregate commercial bank portfolio.

Within this overall pattern of loan usage, the industrial sector took only about 20% of the total. Industrial lending levels are a key indicator of the potential economic returns to any national liberalization policy. In the longer run, productive private sector investment in enterprises with relatively steady payouts over the medium- and long-term are the engines upon which a liberal economy must depend. Once the heady days of financing hair dryers and tape players are over, the financial sector has to begin to direct substantial resources into the productive sector or the liberalization bubble will burst. In reviewing the composite commercial loan portfolio for 1981, two features of importance to the private sector stand out clearly: (1) the private sector holds more than two-thirds of commercial industrial loans, and (2) there are a significant number of industrial subsectors where the private sector is getting the major share of new commercial finance (including

TABLE 3 *Commercial Bank Loans Classified by Purpose and Term (as of June 30, 1981)*

Purpose of Loan	*Amount*		*Percentage of all Loans*			
	Rs millions	*% of total*	*Short term*	*Medium term*	*Long term*	*All loans*
Commercial	9,186.7	49.0	79.3	16.9	3.8	100.0
Financial	449.9	2.4	48.2	34.1	17.7	100.0
Agricultural	2,682.4	14.3	57.4	32.4	10.2	100.0
Industrial	3,453.9	18.4	74.5	20.1	5.4	100.0
Tourism	189.5	1.0	36.6	34.6	28.8	100.0
Engineering and bldg. construction	392.4	2.1	81.9	14.5	3.6	100.0
Mining and fishing	219.1	1.2	36.8	31.0	32.2	100.0
Housing	926.8	4.9	22.4	34.5	43.1	100.0
Consumption	363.1	1.9	44.9	46.8	8.3	100.0
Other advances	888.4	4.8	39.7	17.1	43.2	100.0
Total	18,752.2	100.0	68.3	21.9	9.8	100.0
Advances to Free Trade Zone enterprises	27.9	100.0	59.1	14.5	26.4	100.0

SOURCE: Sri Lanka Banking Control Department.

rubber and plastics, wearing apparel, basic and fabricated metal products, etc.).

While there is a major need to deepen and diversify the financial base of Sri Lanka's young industrial sector, these early signs are encouraging. There is some talk of a liquidity squeeze in the coming year as the government goes more heavily into the market to finance local currency budgetary deficits. The effects of this squeeze on the currently positive trends in industrial finance are difficult to predict. The situation is not altogether dissimilar to that in the U.S. in 1981/1982 in which the government and corporations competed for longer term money in a tight market, driving capital costs up at a time when government policy was otherwise favorable to private sector expansion. That a relative newcomer to the liberalization game like Sri Lanka should face some of the same monetary and fiscal dilemmas which plague advanced industrial economies is not surprising. It may be particularly important, however, that Sri Lanka receives the right mixture of external advice and support to chart a safe path through the coming budgetary crunch in ways that do not reverse the remarkable early growth in the productive private sector since 1977.

THE DEVELOPMENT OF CAPITAL MARKETS

Despite the growing range and sophistication of banking institutions in Sri Lanka, there are a great many gaps in the structure of the financial and capital markets. These gaps are greater on the capital side, however, which is not unusual for a country in the early stages of liberalization. Even socialist governments use banking and financial services, so these tend to develop (at least to a certain level) under all economic regimes. Only a relatively liberal economy needs to generate private equity capital, however, and it is in the natural order of things that capital market institutions grow more slowly than financial market institutions. The current government has given extremely attractive incentives for equity investment (approved projects can sell shares which qualify the buyer for a 100% tax deduction, effectively subsidizing share costs by 50% for the majority of investors who are in the 50% marginal tax bracket). The market structures for handling this equity finance are not yet fully evolved. Four small local brokerage houses make up a secondary market for equities which has more of the characteristics of a "curb market" than a real stock exchange. Offshore and local banks participate in flotations, and new capital issues are rather rapidly sold with the aid of substantial direct advertising in the national media. The principal ventures to enter the public share market have been hotel operations, but even these are encountering problems associated with the small size of the market. New issues in the $0.5 to $5.0 million range have done relatively well, but larger issues have been difficult to sell within the local market. Larger hotel ventures typically start with a 60-70% foreign equity stake and sell the remaining equity in the local market. Issues with large foreign participation (often Indian and Singaporean) have proven particularly attractive to local investors.

Until the capital market structure develops to accommodate the downstream trading of this volume of shares, however, one can anticipate some sticky problems for the Sri Lankan private sector. Antiquated securities' laws and relatively weak market institutions ensure that there is less quality control on equity issues than might be desirable. Considerable potential exists for "watering," insider trading, and the other abuses which have been chronic problems on young Asian and Middle Eastern exchanges. If these things

do happen, then there is the risk of either an investor backlash or, more seriously, a move to overregulation of the capital markets.

The Sri Lankan economy is a small one, and there is no need to build all the trappings of the New York Stock Exchange or even the Hong Kong Exchange at this time. There is, however, a genuine need for enlightened policy guidance in the capital market area so that *appropriate* market institutions and *appropriate* controls and supervision develop to ensure the integrity of the market place. This is an area where the multilateral development banks and Western donors could play an important role over the 1980s in providing the ranges of disinterested technical expertise in capital markets which Sri Lanka must necessarily seek beyond its shores.

The Second Half of the 1980s: Prospects for the Private Sector

The fifth anniversary of the 1977 liberalization has passed, confounding the harbingers of doom and the pundits who have come to believe that Sri Lanka's astute and traditionally cantankerous voters will demand a change of political course at every opportunity. The presidential elections of October 1982 returned the architect of Sri Lanka's *apertura a destra* ("an opening to the right") Junius Richard Jayawardene, to a second six-year term. With 3.4 million of the 6.6 million votes cast, the incumbent president carried 21 of Sri Lanka's 22 districts, losing only in Jaffna where separatist issues rather than economic ideology shaped the electoral competition. While important and useful changes in Sri Lanka's economy have been wrought since 1977, the economic distortions and human dislocation of the liberalization are still far from resolution. That these are a natural and inevitable consequence of major policy transitions is no comfort to those voters who have experienced either the *reality* of reduced living standards or the *perception* that their living standards have declined. As the pattern of income and wealth distribution alter within an economy, there are inescapable centers of bitterness and resentment from less-favored sectors of the populace. While economists can find much to praise in the liberalization and can be sustained by their faith that "right policies" are bound to produce a better life for everyone in the long run, the liberalization has not yet proceeded to the stage where those universal benefits are obvious to everyone.

The largest uncertainty facing the Sri Lankan private sector in 1983 is whether the increasingly probable move from a UNP government to a multiparty national government could unravel the policy framework set in place after 1977. Optimists within the business community like to argue that the benefits in terms of visible growth and improved efficiency are already so great that an expanded government would find it imprudent to dismantle the framework within which the private sector now operates. The referendum of December 22, 1982, amended the Sri Lankan constitution to permit the current parliament to sit until August 1989. Somewhat more than 3 million Sri Lankan voters supported the amendment, but the referendum carried only 15 of Sri Lanka's 22 districts. Pessimists in the private sector point to the relative thinness of UNP margins as an early warning that the government will have to broaden its base by accommodating some elements of the center-left. The costs of such an accommodation could include some backsliding on the government's liberalization program. In any event, a wholesale return to the socialist economy of the 1970s seems unlikely in the near term. The consensus of moderate and conservative opinion seems to be that another six years of liberal economic policies will be sufficient to move the center-point of Ceylon's politics significantly to the right, and that no future non-Marxist government would be prepared to abandon a basic commitment to the free market. A number of western economies are asking the voters to demonstrate additional patience to allow classic liberal prescriptions to work their magic. The October elections and December referendum suggest that Sri Lankan voters still have considerable reserves of patience as they reconfirm a government and a policy which have only gone half the distance.

There is still uncertainty as to whether the dual UNP victories of 1982 signalled an unqualified mandate for the continuation of the 1977 economic policies, or whether they reflect the personal triumph of a candidate of national standing over a somewhat obscure Kandyan landlord whose five year tenure as an SLFP minister of agriculture simply did not carry the electoral glamour of his opponent. The sharp drop in turnout between the presidential election (over 81%) and the referendum (71%) may be a signal of the gap between President Jayewardene's personal support and the support for the UNP record since 1977. These uncertainties notwithstanding, the unprecedented double term for the UNP may prove to be a landmark in Sri Lanka's economic development. With a full decade to rebuild the economy along the Singaporean lines favored by the current leadership, Sri Lanka might move from its status as a social *wunderkind* (with remarkable welfare for a poor country) to join the junior ranks of the economic *wunderkinder* in Asia who have found economic liberalization to be the successful path to high growth *and* high welfare. Were this to happen, Sri Lanka would be the only member of this elect class to have achieved substantial growth and equity within the framework of a free and democratic political system. Economic liberalism has been discredited as the path to development in the Third World by many commentators who point to the political and moral costs of the Korean/Taiwanese/Singapore models. Sri Lanka offers a rare opportunity for a reaffirmation of the 19th century belief that economic liberalism and political liberalism need not be inimical.

Notes

1. Government of Sri Lanka, *Greater Colombo Economic Rehabilitation Area*, November 1, 1977.